

Intelligence MEMOS



From: Dan Ciuriak and Jingliang Xiao
To: The Honourable François-Philippe Champagne, Minister of International Trade
Date: January 12, 2017
Re: **THE DANGER WITH RETALIATORY TARIFFS**

Congratulations on your appointment as Minister of International Trade at this momentous juncture in Canada's international economic relations. The election of Donald J. Trump as President of the United States on a platform predicated on renegotiating what he has described as bad trade deals for the United States and repatriating industrial activity to that country, raises the question of how Canada would be affected and how it should react in the event the United States moves unilaterally to implement protectionist policies.

Canada is the single-most exposed country to trade with the United States. In a forthcoming C.D. Howe working paper, we assess the implications of a hypothetical US protectionist measure – a 10% tariff surcharge on all imports unilaterally imposed by the United States on all its trade partners – to put some numbers around what such a policy might imply for all parties. We also consider the implications of a retaliatory tariff by Canada.

While our results suggest that higher tariffs could play to the United States' advantage in certain ways as it improves its terms of trade (price of exports relative to price of imports), higher tariffs would set in train mechanisms, such as a stronger US dollar, that would likely reduce US exports as well as imports and have consequential negative impacts on real GDP, and productivity there. The implications for US economic welfare in aggregate would be modest under these outcomes, since the terms of trade gains would partly offset the reduction of output.

Canada would take a significant hit under this scenario, with the heaviest blow being to the automotive sector, which is heavily focused on exports to the United States and would have a difficult time diversifying to other markets. There would be handful of Canadian winners, as the international trade deck is reshuffled to take account of the changed relative cost structures that emerge from the protectionist move.

Retaliation by Canada would no doubt be tempting to some, but would significantly magnify the damage domestically, while having little deterrent effect on US real GDP or production. Generally, the sectors hurt by any Canadian protectionist retaliation would be the more technology-intensive sectors. Canada is better off economically by not retaliating.

Canada has a long history of trade shocks imposed by its closest friends and trading partners. Historically, when access to the British or US markets has been compromised, Canada has traditionally not retaliated but pursued new markets. The exception is Canada's retaliation to the infamous US Smoot-Hawley Tariff of 1930, a move that contributed to the Great Depression. Our results thus endorse the traditional Canadian response to trade shocks.

By taxing imports the United States could improve its terms of trade and thus gain some price gains alongside the damage to its own production. An opportunistic exploitation of this phenomenon under a Trump presidency cannot be ruled out – although the result would run counter to the strategic aim of increasing US output. But a retaliatory response by Canada would compound the damage.

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